

APPENDIX

FOMC BRIEFING - P.R. FISHER

May 23rd, 1995

Mr. Chairman:

I will first discuss current conditions in interest rate markets and then some of the factors contributing to recent exchange rate movements before reviewing foreign and then domestic operations.

Interest rates and interest rate expectations have come down considerably since your last meeting, with particularly sharp movements during the first weeks of May. While the economic data releases provided the impetus for these changes, the pace and the extent of the markets' most recent movements have been significantly affected by the participants' positions.

Through early May, many dealers continued to lean their fixed-income positions to the short side, remaining skeptical that the softer outlook would be sustained. But as customer demand kept pulling them shorter, dealers were forced to catch up with the market. Managers of mortgage-backed securities portfolios have sought to offset the risk of declining duration from pre-payments by outright purchases of Treasury issues and other duration-extending trades. Finally, foreign asset-managers

seemed to arrive at the picnic a little late, contributing to increased volume and price movements during overnight trading.

As a result of the sharp movement, there is a bit of a divergence between the current pricing in the market and market sentiment as expressed by dealers and market analysts.

Yields and prices now appear to reflect a tension between the expectation that monetary policy will remain in the current posture through the end of the year, on the one hand, and the expectation that the Committee might move to lower the Fed Funds rate as early as the summer, on the other hand. Thus, the spread between Fed Funds and the two-year note stands at only basis points and the structure of Fed Funds futures contracts suggests that the market is skewed slightly toward the probability of an ease in policy over the coming months.

Opinions and market sentiment, however, are divided along a wider spectrum. At one end, there are those who think the Committee might need to move rates lower either soon or by the turn of the year. But at the other end of the spectrum are many who believe that the Committee will be raising rates by the fourth quarter, as a result of what they anticipate may be a rebound in economic activity in the second half of the year.

This latter view has been priced out of the market: Those who expressed this view in their positions found it too expensive to maintain in the face of current data and the rush of position adjustments.

Turning to the dollar, in American press accounts, much has been made of the dollar's spurt upward on May 11th after the late-night House Budget Committee vote. The improving tone of American fiscal policy deliberations was certainly one of the factors which helped the dollar crawl up, off its back. But by focusing just on our own side of the dollar's exchange rates, we may be obscuring the potential significance of developments on the other side.

When the Bundesbank surprised the market by lowering rates 50 basis points on March 30th, many market participants expressed skepticism, viewing the move as a sop for the French franc and the dollar and potentially damaging to Bundesbank credibility. The quick reversal of the dollar's immediate rise appeared both to reflect and to vindicate this view.

Since then, however, expectations for the German economy and German monetary policy have shifted modestly, but perceptibly lower. Gone are the forecasts of 3 percent growth in 1996 and of rising interest rates. Indications of weaker current activity, continuing weak headline M3 data, and lower activity forecasts

have contributed to declining short-term German interest rates and to an increasing focus on whether and when the Bundesbank might lower official rates again.

While a change has been less evident in dollar-yen, there is a gnawing concern among market participants about the absence of plausible remedies for the persistent weakness of the Japanese economy and the Japanese financial sector. The package of interest rate reductions and fiscal stimulus offered up by the Japanese authorities was viewed mostly as

While there are few who will state conclusively that the Japanese economy is entering a deflationary spiral, there are many who express the concern that this could occur--particularly when they contemplate the condition of the Japanese banks. Thus, it appears that with the yen's recent burst of strength, market participants, who have traded in the belief that a weak Japanese economy would continuously lead to a stronger yen, have recently begun to ponder the limits of this hypothesis.

So while trying to avoid the risk of over-interpreting the dollar's modest correction from all-time lows, I urge you to notice not only the markets' correction from overly negative views about matters North American, but also the tentative signs of the markets' reconsideration of its previously unrestrained appetite for marks and yen.

In foreign operations, on Monday April 3rd the Desk intervened in Asian markets and in New York trading, selling a total of 1.5 billion dollars worth of marks and yen, evenly divided between the two currencies and also evenly divided between the System Account and the ESF. In these operations we were joined by the Bank of Japan.

On Wednesday, April 5th, we intervened in New York trading, selling a total of 1.1 billion dollars worth of marks and yen, 850 million worth of marks and 250 million worth of yen, again evenly divided with the ESF. On this occasion, we were joined by both the Bank of Japan and the Bundesbank. At our request, other central banks refrained from participating on April 5th, as we sought to focus the market's attention on the G-3 nature of the exercise and to distinguish the effort from previous, concerted interventions.

On neither occasion did we have much impact on dollar-yen, as heavy demand for yen continued into the new fiscal year -- leading dollar-yen to the new, historic low of 79.75 on April 19th. However, even as the dollar continued to weaken against the yen, dollar-mark did stabilize in the days following the April 5th intervention with the Bundesbank.

In other foreign operations, for value May 3rd we transacted the first of the three possible rollovers of the outstanding 1 billion dollar 90-day swap with the Bank of Mexico and we did the same on the ESF's short-term 1 billion dollar outstanding swap.

As a result of drawings on the ESF's medium term facility of 3 billion on April 19th and 2 billion on May 19th, the Mexican authorities now have a total of 10 billion dollars outstanding on the U.S. facilities: 8 billion on the Treasury's medium term facility and 1 billion on each of two short-term facilities.

In domestic operations, temporary transactions were used to build upon an outright purchase of 4 and a half billion dollars of coupon securities on April 4th.

The Funds rate traded generally close to or just slightly above the expected rate of 6 percent, with upward pressure coming at the end of the first quarter, with the April tax date, and with Treasury coupon settlements.

Looking forward, according to current estimates, the need to add reserves is projected to grow steadily reaching about 10 billion dollars at the time of your next meeting and 12 billion in the maintenance period immediately after the next meeting. These reserve needs arise principally from seasonal increases in domestic demand for currency as well as continued expected

currency outflows to foreign countries. Under these circumstances, I would like to ask the Committee to increase the normal leeway permitted for permanent changes in the System portfolio from 8 billion to 10 billion dollars, in order to provide the Desk with the flexibility to conduct two outright purchases, if that should prove necessary.

Mr. Chairman, I would be pleased to answer questions on my report. I will need separate votes of the Committee to ratify the Desk's foreign and domestic operations and for approval to increase the intermeeting leeway from 8 to 10 billion.

Michael J. Prell
May 23, 1995

FOMC BRIEFING

We've received a number of impressive data since the last meeting: Housing starts fell 6-1/2 percent further in March and failed to rebound at all in April. Sales of light vehicles plummeted 11 percent last month. Payroll growth ground to a halt in April, and the unemployment rate jumped three-tenths of a point, to a seven-month high of 6.8 percent. And core CPI inflation ran at more than a 4 percent annual rate over the past two months.

All of this would seem to smack of serious stagflation and some difficult decisions for monetary policy. But the stock and bond markets have greeted these developments with powerful rallies.

To the layman, such a confluence of events might be confusing and disorienting. But, for your expert staff, it was a piece of cake to sort all of this out--and indeed to persuade ourselves that we could assure you that everything is going according to plan! But, seriously, while we see plenty of risks in the outlook, we're still reasonably comfortable with our prior projection that a stable fed funds rate would yield a fairly soft landing for the economy, albeit one with a slight increase in inflation relative to last year's pace.

To be sure, on the real side, it appears that the economy did weaken more quickly than we predicted. More to the point, sales of homes and of autos and some other consumer goods all fell off more sharply than producers and distributors had anticipated, and inventories backed up. Producers have moved now to gear down their output. The question is whether we can come through this adjustment

with the momentum of expansion still intact. We think the answer is yes, for three major reasons:

First, aside from motor vehicles, we don't think that the inventory overhang is so large as to require more than small production adjustments in order to get stocks into line with more subdued sales trends. Discounting will help clear out some of the excess stocks, admittedly at the cost of some short-run hits to profits. And foreign producers will share in the output adjustment as firms here trim their imports.

The second reason for our sanguine outlook is that we think it likely that household demand will pick up some even if employment and income are less robust in coming months. Though sentiment indicators have shown mixed changes of late, they generally have remained at healthy levels, and the rise in securities prices has added substantially to household wealth. Despite the run-up in consumer debt, households still seem to be paying their bills, and lenders remain enthusiastic about extending credit to them--so we don't see a major financial impediment on that front. After three years of hefty gains in durables sales, there may not be a lot of pent-up demand left; but we think it reasonable to look for some near-term bounceback in purchases of vehicles after the recent dive and for a moderate rise in both durables and other outlays thereafter. Meanwhile, in the housing market, there are already signs that the big drop in mortgage rates is leading to a firming of demand for single-family homes; construction should follow before long, as the inventory of unsold units is reduced.

Finally, we believe that there will continue to be substantial impetus to growth coming from the capital goods and export sectors. There are hints here and there of some deceleration in

equipment demand, but this is scarcely surprising in light of the dimensions of the surge we've experienced over the past few years. Overall, the trends of orders and backlogs suggest that production of equipment will continue to rise at a good clip in the near term. And, on the structures side, many of the building plans developed over the past year or so, during which operating rates and profits soared, are just beginning to be implemented; good gains in nonresidential construction seem reasonably assured for at least a few quarters.

The same is true of exports, where the trends, after allowance for the Mexican adjustment, appear quite favorable. Indeed, judging by some of the outside forecasts that look for a greater acceleration of GDP later this year, you would think that this is a sector containing one of the bigger upside risks in our forecast. The more optimistic view is that the U.S. trade balance will improve spectacularly, given our competitive position at recent exchange rates. We of course have taken the dollar's exchange value into consideration--including the fact that it has declined less on a broad trade-weighted basis than it has against the mark and the yen. We also perceive that growth in activity is now rather hesitant in some important foreign economies and likely to be less rapid on a worldwide basis than it was last year. The bottom line, though, is that exports can be expected to provide a solid contribution to output growth in this country.

Now that I hopefully have eliminated any doubts that you might have had about the accuracy of our output forecast, let me turn to the inflation side. We are projecting that, after rising three- or four-tenths per month from January through April, the core CPI will generally rise just two- or three-tenths per month over the rest of the year.

It is not hard to come up with a list of reasons to worry that the outcome could be worse--rising materials costs and increases in import prices being among those coming immediately to mind. But, given the projected decline in factory utilization rates and stabilization of the dollar, those pressures should ease over the second half of the year. And, in the short run, as I've noted, the efforts to clear away unwanted inventories should impose some extra restraint on pricing. Moreover, while we don't want to get carried away with the slicing and dicing of the indexes, we have noted that the rise in interest rates added to measured inflation over the past year because auto loan rates are included in the CPI; on our interest rate assumption, this should no longer be a significant problem. Finally, a more general consideration is that--despite the tightening of the labor market that has occurred--compensation still seems to be rising moderately, contributing to a subdued trend of unit labor costs.

All things considered, we believe our price forecast balances the risks in the outlook. By our reckoning, the combination of only a small overshooting of full employment and a quick downshifting to moderate growth implies an environment in which the pickup in the underlying trend of inflation is likely to be very gradual--as it is in our forecast, if one looks at the core CPI acceleration of just several tenths between 1994 and 1996.

To be sure, in evaluating the inflation outlook, one should not overlook the food and energy sectors. Recent news on both these fronts suggests a basis for some concern. Oil prices have been running higher than we expected, and our energy price forecast anticipates a drop-back in coming months. And we've largely ignored the potential adverse effects on crops--and thence on food prices--of

the recent rains in the Midwest. Shocks arising on either of these fronts could reverberate through the system and create broader inflation problems. At this juncture, we believe that it is too early to build more pessimistic supply assumptions into our baseline forecast. But a cautionary note probably should be sounded.

In closing, I would note briefly one other potentially important issue with respect to the assumptions of our baseline forecast, namely the path of fiscal policy. I won't expound at length on this subject today. What the Republicans in the Congress have put on the table clearly represents a much more aggressive attack on the budget deficit than we have assumed, but it will almost surely be several months before the outcome of the political conflict will be known, and several more months before the budgetary effects become significant. Under the circumstances, it seemed reasonable to adhere for the time being to our more conservative assumptions and simply include in the Greenbook a model-generated reading on what orders of magnitude we might be dealing with, in terms of macroeconomic effects. We may have some better clues as to what will be confronting us when we meet next, but I'm certainly not making any promises on that score.

Mr. Chairman, that concludes my prepared remarks. Ted and I will be happy to attempt to answer any questions the Committee might have.

May 23, 1995

FOMC Briefing
Donald L. Kohn

The Committee would seem to have ample reasons for keeping policy on hold at this meeting. Inflation has picked up this year, but the expansion has slowed--by more than expected--and resource utilization levels have declined, promising to limit any uptick in inflation. While most observers see inflation as higher in 1995 and 1996 than in 1994, there is little evidence of any ongoing deterioration in inflation expectations. In the staff forecast, steady federal funds rates bring the economy in around its potential, with inflation running just a little above 1994. In particular, with the dimensions of the deceleration in final demand still uncertain, the Committee might want to await additional information before deciding its next step.

Obviously, there are significant risks on both sides of the outlook--risks that, as Peter noted, seem to be reflected in a certain diversity among market observers on the question of the direction of your next move. In brief, markets appear to see the current federal funds rate as a bit more restrictive than does the staff, and have priced in an easing action in the second half of the year. On the other hand, many of the economists advising market makers believe that you will need to tighten again to keep inflation from accelerating appreciably. I thought it might be instructive to take a closer look at these two views to help gauge sources of risk to the outlook.

Markets evidently have taken incoming information on the economy as suggesting a considerably weaker underlying path for aggregate demand than previously anticipated. They may also be reacting

to perceptions of higher odds on substantial fiscal restraint in coming years. The process this year of revising the expected trajectory for interest rates has provided considerable additional financial impetus for spending, through its effects on domestic capital markets and the foreign exchange value of the dollar. Still, short-term real rates remain above long-run averages, and markets seem to be saying that given their assessment of aggregate demand, the current structure of rates is perhaps a little too high to meet what they take to be the Committee's objectives.

This sort of result can also be found in the results from John Taylor's policy rule, which as you may remember, tracks the FOMC's policy decisions on the federal funds rate fairly well since 1987 by relating the real federal funds rate to deviations of unemployment and inflation from longer-term objectives. The federal funds rate that falls out of this formula is now significantly below 6 percent, suggesting that the FOMC is running a tighter policy relative to its behavior over the last eight years--though this conclusion depends importantly on using the deflator rather than the CPI to measure inflation.

In judging the possible implications for policy of the market's assessment, however, there are a few caveats to consider. For one, markets don't seem to be expecting much ease and therefore don't see policy now as highly restrictive. Most of the drop in intermediate- and long-term rates since late last year represents a recision of previously expected tightening. Second, implicit in market expectations may be higher inflation than you would find acceptable. Blue Chip forecasters, for example, have been predicting 3-1/2 percent CPI inflation both this year and next. Third, although markets are in

effect guessing at the strength of future aggregate demand, whether changes in those guesses are based on incoming data about current activity or on anticipated fiscal policy might have different implications for the time path of monetary policy. In the former case, financial markets are trying to catch up to what they perceive already to be occurring in the real economy, and if they are right, short-term rates should adjust on schedule to validate their judgment. With regard to fiscal policy, markets are projecting future government actions and the response of private demand and the Federal Reserve. The latter situation may contain greater odds on financial markets getting ahead of themselves--that is compensating with lower rates for substantial decreases in aggregate demand which, if they occur, may be well into the future. In this situation, declines in intermediate- and longer-term rates could have significant net stimulative effects over an interim period, arguing for holding off for a time on any adjustment in short-term rates, taking account of the different lags for fiscal and monetary policy.

Apparently, many market economists do view the markets as having over-reacted to the incoming economic data and fiscal prospects. They see the drop in interest and exchange rates as providing unneeded impetus to the economy later this year and early in 1996, especially when taken together with the atypical continued easing of credit supply conditions and the substantial rise in equity prices. Many of these economists have postponed the date of expected Federal Reserve tightening as a consequence of the incoming data, but they still see a need to raise short-term rates to keep the economy from operating substantially beyond its potential and inflation from establishing an upward trend.

Adding to the difficulty in interpreting the current situation--and perhaps to concerns about an economic resurgence later in the year--has been the tendency for interest rates around the industrialized world to tumble at the same time. To a degree this is an understandable response to the spending shock in the U.S., which has been transmitted to other countries through the decline in the dollar, and which foreign monetary authorities are trying to offset, given the degree of slack in their own economies. But for the scale of the downward move in rates to be warranted, negative spending surprises in other countries--of which there have been some--or the correction of rates that had been too high would seem to be required.

The possibility that interest and exchange rates have fallen below equilibrium levels cannot be ruled out--there are several academic studies indicating that market price movements frequently have been larger than justified by fundamentals. Still some caution in this regard is warranted as well. Market economists may be reacting to the fact that they failed to call the drop in interest and exchange rates--and therefore can't see them as justified. Moreover, some of the previous expectations of further Federal Reserve tightening seemed to be based on comparisons with the size of rate movements in prior business cycles. But, by beginning to raise rates in advance of an uptick in inflation, and by starting from a base of zero rather than negative real rates, the extent to which nominal and real rates need to rise likely was reduced considerably. As noted in the greenbook and bluebook, the staff itself expects some back up in rates as the economy comes in less weak than the market seems to have built in. But the size of that correction is relatively small, and not associated with a change in the federal funds rate.

In days--or years--of yore, we might have looked to the behavior of money and credit for clues about how the risks to the outlook are resolving themselves. In fact, money and credit over recent quarters have resumed growth roughly in line with historical experience and are broadly supportive of the staff outlook for moderate expansion of nominal GDP with limited increases in inflation. Private credit growth has been strong, driven in part by the increasingly favorable supply conditions. Banks reported again this month that they continue to ease bank lending terms, and to a lesser extent standards, especially for business loans. Spreads in securities markets remain very narrow, indicating few restraints on credit availability from this source. But increases in private borrowing have primarily substituted for diminished demands from government, and overall credit growth remains in the neighborhood of 5 percent, close to the actual and expected rate of growth of nominal GDP.

The strength of private borrowing from banks has boosted broad measures of money. M3 is a little above its annual range, but this range is rather low by historical standards and by comparison with M2. The latter aggregate also has picked up as opportunity costs have leveled out or even declined slightly with the rise in rates on small time deposits and drop in market rates. The level of M2 remains depressed relative to its usual determinants, but its growth has been in line with changes in income and opportunity costs. Meanwhile, narrow measures of money--M1 and the monetary base--have decelerated this year. In sum, the broadest measures of credit and money seem consistent with ample demands for and supplies of credit to support

continued growth of spending: narrower measures are constrained, reflecting the effects of past interest rate increases, suggestive of limits to the strength in spending and increases in inflation.

This discussion of the disparate views in the market suggests risks to both sides of the staff forecast. If the Committee shares this judgment, it might consider shifting to a symmetrical directive. Although inflation is higher than last year, the odds on further increases might appear lower with the economy operating closer to its estimated potential than at the last meeting. In addition, the surprises in the incoming data since the asymmetrical directive was adopted have been more on the side of weaker final demand and damped labor costs--both also suggesting reduced risk of further acceleration in prices than perceived last time and perhaps some greater chance of business cycle dynamics pushing output significantly below potential. In these circumstances, the Committee might not want to react more promptly or strongly to incoming data suggesting either higher inflation or slower growth--and a symmetrical directive would convey this instruction.

Of course, inflation has risen, and many forecasts are for it to remain noticeably above its level of last year. If the Committee still saw the risks as tilted toward even higher inflation, or was concerned about eventually reversing the movement away from its stated long-run goal of price stability, it could retain the current asymmetrical directive toward tightening. On the other hand, an asymmetrical directive toward ease would be appropriate if the Committee saw a substantial probability that weakness in final demands would persist or deepen, and wanted to react especially promptly to any signs that this was occurring.